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In The
Supreme Court of the United States
October Term, 1986

KATHRYN B. CELAURO
as successor in interest to

MARTHA B. OLSEN, COMMISSIONER OF REVENUE,
STATE OF TENNESSEE,

Petitioner,

vs.

MIDLAND BANK & TRUST COMPANY, ET AL.,

Respondent.

On Petition For A Writ Of Certiorari To The
Supreme Court Of Tennessee

PETITIONER'S REPLY BRIEF

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PETITIONER'S REPLY BRIEF

1. The question presented in the Commissioner's Petition involves the scope of the exemption of federal bonds provided by the federal immunity doctrine as codified in 31 U.S.C. § 3124(a), i.e., whether gross income from federal bonds must be deducted from a net income tax base thereby sheltering massive amounts of unrelated income or whether the net federal bond income must be deducted from that net income tax base. Respondents attempt to avoid this issue by contending that this case involves nothing more than a relitigation of *Memphis Bank and Trust Co. v. Garner*, 459 U.S. 392 (1983).

Contrary to Respondents' representations, *Memphis Bank* does not control this case because the facts in this instance are different from the situation found in *Memphis Bank*. The Petitioner agrees that the tax statute here, the Tennessee Corporate Excise Tax statute, was utilized as the tax base of the Tennessee Bank Tax statute at issue in *Memphis Bank*. However, the tax calculation in the present case is different from the calculation in *Memphis Bank*. In this case, federal bond income has been completely removed from the net earnings tax base whereas in *Memphis Bank* federal bond income was included in the tax base. Net federal bond income was taxed in *Memphis Bank* but in the present case, federal bond income is exempted by the deduction of the net federal bond income.

The Commissioner of Revenue was not a party to *Memphis Bank* (Pet. App. A-17) but agrees that federal bond income must be removed from the net earnings tax base.¹ The Tennessee Corporate Excise Tax in Tenn. Code Ann. § 67-2704(b)(2)(B) excludes from the net earnings tax base any income, such as federal bond income, which is included in "federal taxable income" but which is not within the power of the State of Tennessee to tax. 31 U.S.C. § 3124 (a) determines the extent to which federal bond income is exempted from state taxation and, thus, required to be re-

1. The Commissioner agreed in the trial court and before the Tennessee Supreme Court that federal bond income in its entirety must be removed from the Tennessee Excise Tax base. The Respondents assert a false issue when they suggest that the Commissioner is asking to have Tennessee bonds included in the tax base. This is not the Commissioner's position. That issue does not even arise indirectly in this petition and this Court need not be concerned with that suggestion of the Respondents.

moved from the Tennessee excise tax base. The determination of the means by which to remove federal bond income from the tax base is the issue presented in this case.²

This case is factually distinguishable from the situation presented in *Memphis Bank*. The facts here are simply that federal bond income has been removed from the excise tax base to the extent originally included in that base. The two components of gross federal bond income are the net earnings from federal bonds and the expenses associated with federal bonds. On their tax returns, the Respondents deducted expenses associated with federal bonds from gross income to arrive at "federal taxable income." When the "net income" from the federal bonds is removed from "federal taxable income," the full amount of the gross income from federal bonds is removed from the net earnings tax base. The reason is that in order to determine the amount of net income one has already subtracted the applicable expenses related to the federal bond income.

The deduction of gross federal bond income from a net income tax base does more than exempt federal bond income from tax. The Tennessee Supreme Court erroneously interprets federal law to permit Respondents to deduct from gross income their expenses related to federal bonds and then to deduct their gross federal bond income from their net income tax base. This gives the banks a

2. In *Memphis Bank*, the amount of the local bank tax to be refunded if the taxpayer prevailed on its constitutional challenge was stipulated and the issue of the scope of the exemption was not considered there. (Pet. App. A-19 to A-20).

double deduction of expenses. This Court said in *First National Bank of Atlanta v. Bartow County*, 470 U.S. 583, 593 (1985):

[T]he scope of the exemption for Government obligations . . . need not be a total exclusion, but, instead, may be limited by charging tax-exempt obligations and *interest*, their fair share of related *expenses* or burdens. (Emphasis supplied)

A situation similar to the present case arose in *State ex rel. Douglas v. Karnes*, 346 N.W.2d 231 (Neb. 1984). In that case, the Nebraska Supreme Court held that federal bond income could not be included in the net income tax base of the Nebraska Franchise Tax because that tax base was discriminatory under the holding in *Memphis Bank*. The court removed the net federal bond income from the tax base and charged that income with its fair share of related expenses. The court said that the removal of the federal bond income net of expenses was "analogous" to the disallowance of expenses relative to state bonds by I.R.C. § 265. Tennessee's exclusion based on a pro rata exclusion of the federal bond income is grounded on these same principles which were approved by this Court in *Bartow*. Also see *United States v. Atlas Life Insurance Co.*, 381 U.S. 233 (1965).

2. All federal bond income has been removed from the net earnings tax base despite the unsupported assertion of the Respondents (Br. in Opp. 9). The exemption requirement stated in the first sentence of 31 U.S.C. § 3124 (a) has been satisfied by the removal of the federal bond

income and there can be no discriminatory taxation of federal bond income because that income is not being taxed at all.

The Tennessee Supreme Court attempted to determine the scope of the immunity of federal bond income without consideration of the principles stated in *First National Bank of Atlanta v. Bartow County*, 470 U.S. 583 (1985). In defense of the court's ruling the Respondents assert that the *Bartow* approach is not applicable to a discriminatory state tax. Footnote 6 cited from *Bartow* by Respondents (Br. in Opp. 8) does not support this contention. The note merely says that *Schuykill Trust Company v. Pennsylvania*, 296 U.S. 113 (1935) involved the issue of whether a discriminatory state share tax could validly include federal bonds and did not consider the issue of how to exclude those bonds from an invalid tax. It is clear that federal bonds cannot be included in state tax calculations unless the state tax is a form of taxation authorized in 31 U.S.C. § 3124(a). If the form of taxation is not authorized by Congress, then the federal bond income must be immunized from state taxation. The use of a method such as the pro rata method accepted by this Court in *Bartow* is a fair and reasonable means to eliminate the federal bond income from the "federal taxable income" base. The Respondents have not demonstrated why this method is not appropriate. Contrary to Respondents' contentions, this Court in *Schuykill Trust Co. v. Commonwealth of Pennsylvania*, 302 U.S. 506 (1938) held that discriminatory taxation of federal obligations was properly eliminated by a pro rata deduction of those bonds from the calculation of a state share tax.

In *Bartow*, this Court analyzed the scope of the exemption required by 31 U.S.C. § 3124(a) in light of the following test provided in *Missouri ex rel. Missouri Ins. Co. v. Gehner*, 281 U.S. 313 (1930):

“[A] State may not subject one to a greater burden upon his taxable property merely because he owns tax-exempt government securities.” *Id.*, at 312, citing *National Life Ins. Co. v. United States*, 277 U.S. 508 (1928).

470 U.S. at 590.

This test was utilized in *Bartow* to determine that a pro rata deduction method satisfied the requirement of 31 U.S.C. § 3124(a) that federal bonds be excluded to the extent present in the state tax base. This test balances the requirement that federal bonds be immunized from state taxation while not granting “an affirmative benefit [to the taxpayer] at the expense of the taxing power of the state by relieving the taxpayer of the full burden of taxation” on his taxable sources. Under this test, it is clear that no indirect taxation remains after federal bond income is removed from the tax base, if the tax on the taxpayer’s remaining income does not increase because of owning federal bonds.

There is no indirect tax on the federal bond income in this case. This point is illustrated by a simple example in which it is assumed that in one tax year the taxpayer has no income from federal bonds but has other net income of

\$100,000. In the second tax year, the taxpayer has \$10,000 in net income from federal bonds and other net income of \$100,000. The total net income in the second year is \$110,000 for federal tax purposes. Under the Commissioner's position, 31 U.S.C. § 3124(a) would require that the \$10,000 in net federal bond income be removed from the federal tax base to arrive at the Tennessee net earnings tax base. Since the resulting tax base for Tennessee purposes is \$100,000 in both tax years, it is clear that the taxpayer's tax on other income has not increased because he held federal bonds. The *Gehner* test has been satisfied by the removal of the net federal bond income.

Also, contrary to the Respondents' claim, the case of *Forbes, Inc. v. Department of Finance, City of New York*, 66 N.Y.2d 243, 487 N.E.2d 251 (1985), cert. denied, No. 85-1371 (U.S. 1986) is not similar to the present case. *Forbes* did not address the issue of how to eliminate the federal bond income from the tax base. In that case, the federal bond income was being taxed and the rate of tax increased when the taxpayer invested in federal bonds. There was discriminatory taxation of the federal bond income in *Forbes*. However, in the present case, the federal bond income is removed from the tax base to eliminate the discriminatory taxation.

CONCLUSION

For the foregoing reasons, as well as those set forth in the petition, the petition should be granted.

Respectfully submitted,

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